STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

The Southern Company,	**)**	
AGL Resources, and	**)**	
Northern Illinois Gas Company	**)**	
d/b/a Nicor Gas Company	**)**	**Docket No. 15-0558**
	)	
Application for Approval of a Reorganization	**)**	
Pursuant to Section 7-204 of the Illinois	**)**	
Public Utilities Act	**)**	

REBUTTAL TESTIMONY OF DAVID J. EFFRON ON BEHALF OF THE PEOPLE OF THE STATE OF ILLINOIS AND THE CITIZENS UTILITY BOARD

AG/CUB Exhibit 4.0

MARCH 31, 2016

ICC DOCKET NO. 15-0558
DIRECT TESTIMONY OF DAVID J. EFFRON
AG/CUB EXHIBIT 4.0

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I. INTRODUCTION

Q. Have you previously submitted testimony in this docket?

A. Yes. I submitted direct testimony on February 3, 2016, marked as AG/CUB Exhibit 1.0. My qualifications and experience are included with my direct testimony.

Q. What is the purpose of your rebuttal testimony?

A. In this rebuttal testimony, I respond to the rebuttal testimony of Joint Applicants ("JA") witness Michael J. Morley, JA Exhibit 6.0.

II. NICOR GAS EARNINGS

Q. Does Mr. Morley agree with your testimony regarding the excess return on equity presently being earned by Nicor Gas?

A. No. He offers three general criticisms of my testimony regarding the return on equity presently being earned by Northern Illinois Gas Company d/b/a Nicor Gas Company ("Nicor Gas" or "Nicor" or "the Company"): 1) I fail to employ "the principle of normalization" in my calculation of the Company's earned return on equity (JA Ex. 6.0 at 4); 2) I improperly employ a "single-issue ratemaking approach" as the basis for my recommendations (*id.* at 5-6); and 3) my recommendations rest on "the application of improper retroactive ratemaking theory" (*id.* at 6).

Q. In your calculation of the Company's earned return on equity in 2014, did you normalize actual revenues and expenses?

A. No. I used the actual results of operations in 2014 to calculate the earned return on equity for that year. I fully agree, in principle, that it is appropriate to normalize revenues and expenses in analyzing the rate of return being produced by a utility's rates. That being said, as I noted in my Direct Testimony, the Company's net income in 2013 would have been about the same as it was in 2014 if the lower depreciation rates implemented as of August 2013 had been in effect for all of 2013. This is an indication that the Company's excess earnings in 2014 were not caused by abnormal or non-recurring conditions.

In response to Attorney General data requests, the Company has now provided financial information for 2015. I show my calculation of the earned return on book equity in 2015[1] on Schedule DJE-2 accompanying this testimony (AG/CUB Exhibit 4.1). In 2015, the Company's net income was $87.5 million. This translates into a return of 11.87% on an average balance of book equity of $737.2 million in 2015. Thus, while the return on book equity in 2015 was lower than it was in 2014, it was still above the Company's authorized return on equity of 10.17%. I would also note that the weather in 2015 was somewhat milder than normal, based on data provided by the Company. The excess return on book equity in 2015 equates to excess net income of $12.5 million, which translates into excess revenues of $21.2 million

Q. Is Mr. Morley correct that you employed a "single-issue ratemaking approach" as the basis for your recommendations?

[1] The return on book equity is based on the Company's financial statements, without adjustments to state income taxes and investment on a ratemaking basis.

A. No. My recommendations were based on the Company's actual results of operations including all revenues and expenses. I did cite the reduction to depreciation rates as the reason for the over-earnings and noted that the over-earnings in 2014 were approximately equal to the reduction to depreciation expenses resulting from the lower depreciation rates. However, I did not recommend a reduction to the Company's rates to reflect the lower depreciation expense without regard to whether the reduced depreciation expense actually resulted in over-earnings.

Single-issue ratemaking, as I understand the term, would entail a reduction to rates to reflect a discrete expense reduction, or an increase to rates to reflect a discrete expense increase, without regard to whether the utility was over or under-earning after incorporating the effect of the specific expense change. My recommendation took into account actual earned return on equity, based on actual revenues and expenses, which included, but were not limited to, the effects of the reduced depreciation rates. In fact, my calculation of excess revenues on Schedule DJE-1 accompanying my Direct Testimony (AG/CUB Exhibit 1.1) was based on the Company's excess return on equity (which incorporates all revenues and expenses), not on the effect of the reduction to its depreciation rates. This is not single-issue ratemaking.

Q. Does your recommendation constitute retroactive ratemaking?

A. No. I am not proposing "a prospective rate decrease to recover revenues from two years ago" (JA Ex. 6.0 at 6), as Mr. Morley asserts. As I clearly explained at pages 8 through 10 of my Direct Testimony, my recommendations were based on an expectation that the Company's over-earnings would continue prospectively. Absent such expectation, a prospective rate reduction would not be appropriate. I was not, and I am not, recommending that rates be reduced prospectively in order to refund to customers excess revenues from 2014. I am not proposing to "reach back in time to claim revenues recovered pursuant to Commission-approved rates" *(id.)*. Rather, my recommendation was intended to address continuing over-earning circumstances, which would tend to be perpetuated and enhanced to the extent that the proposed reorganization ultimately results in any future synergies and/or economies of scale.

Q. Based on your analysis, are Nicor's over-earnings continuing?

A. Yes. Although the 2015 income was lower than the 2014 income or the 2013 income adjusted to annualize the lower depreciation expense, the 2015 income still produced a return on book equity s in excess of Nicor Gas' presently authorized return on equity. I further note that Nicor Gas' presently authorized return on equity was established in Docket No. 08-0363, which was decided in 2009, and the authorized returns on equity have generally decreased since then. For example, in Docket Nos. 14-0224/14-0225 (cons.), decided in early 2015, the Commission authorized a return on equity of 9.05% for North Shore Gas Company and The Peoples Gas Light and Coke Company.[2] This is 1.12 percentage points lower than the 10.17% return on equity that was authorized in Docket No. 08-0363.

Q. Did the Company also provide a calculation of the earned return on common equity in 2015 on a weather-normalized basis?

[2] ICC Docket Nos. 14-0224/0225 (cons.), Second Amendatory Order, February 11, 2015, at page 3, Ordering Paragraph 9.

A. Yes. In response to AG Data Request 4.02, the Company calculated the return on common equity in 2015 as adjusted to reflect normal weather. This calculation was also done on a "ratemaking" basis[3], so as to reflect the return on common equity supporting rate base. I agree that the calculation on a ratemaking basis is appropriate in principle.

I have summarized the Company's earned return on common equity on a ratemaking basis on my Schedule DJE-3 (AG/CUB Exhibit 4.1 at pages 2-3), with one adjustment to the Company's calculation. The Company included one-half of the average balance of short-term debt in its capitalization. I have adjusted the balance of short-term debt in the capitalization to reflect the average balance of short-term debt minus the balance of CWIP accruing AFUDC, which is the method of determining short-term debt in the capitalization approved by the Commission in its original order in Docket No. 08-0363 (Order, March 25, 2009, at 49).

Q. Why did you adjust the balance of short-term debt included in the Company's capitalization?

A. On rehearing in Docket No. 08-0363 the Commission "determined that it is equitable and reasonable to include $127,820,041 in NICOR's capital structure. This conclusion is based on what we believe to be a reasonable estimate, effectively splitting the short-term debt in half. This results in a capital structure that is 95% of rate base, which is close to the 87% and 93% of rate base in previous Nicor cases" (Docket No. 08-0363,

[3] The calculation of a utility company's return on equity on a ratemaking basis takes into account utility operating revenues and expenses as they would be determined in a rate case and the common equity supporting the utility company's rate base.

Order on Rehearing, October 7, 2009, at 13). The Company apparently relied on the Commission's estimate on rehearing in Docket No. 08-0363, which happened to be equal to one-half of the balance of short-term debt at the time of that case. However, the Commission also found that it was reasonable to include short-term debt in the capital structure to the extent that the resulting capitalization was equal to 95% of the Company's rate base. I believe that to be consistent with the Commission's intent in Docket No. 08-0363, and to calculate the return on equity on an appropriate ratemaking basis, it is necessary to employ a method of determining the relevant balance of short-term debt that maintains that relationship between capitalization and rate base.

The average balance of short-term debt minus the balance of CWIP accruing AFUDC (the method adopted by the Commission in its original order in Docket No. 08-0363) is $337.6 million. The resulting capitalization of $1.573 billion is 95.1% of the Company's calculated rate base of $1.654 billion. In my opinion, this is consistent with the Commission's findings on rehearing in Docket No. 08-0363. I have made no other adjustments to the Company's calculation of its earned return on common equity in the calculations that I am presenting here.[4]

Q. What return on common equity, stated on a weather-normalized and ratemaking basis, have you calculated for 2015?

A. With my adjustment to the Company's capitalization, I have calculated a return on common equity of 11.46% in 2015. This exceeds the authorized return on equity by

[4] It is possible that other adjustments might be appropriate.

1.29 percentage points. The excess return on common equity equates to excess net income of $10 million, which translates into excess revenues of $16.9 million.

Q. Have you also calculated what the excess earnings would be if the authorized return on common equity were set at 9.05%?

A. Yes. If the authorized return on common equity were set at 9.05%, the return on common equity of 11.46% would exceed the authorized return on equity by 2.41 percentage points. This equates to excess net income of $18.6 million, which translates into excess revenues of $31.6 million.

Q. Does this conclude your rebuttal testimony?

A. Yes.